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E.O. 12958: DECL: 01/05/2019
TAGS: ECON EFIN PGOV VE
SUBJECT: VENEZUELA'S 2009 ECONOMIC OUTLOOK: GRIM TO DIRE

Classified By: Economic Counselor Darnall Steuart for reasons 1.4 (b) and (d).

¶1. (C) Summary: If oil prices remain at or near current levels, 2009 will be an extremely difficult year, perhaps even a crisis year, for the Venezuelan economy. Most independent analysts expect anemic economic growth or a slight contraction; inflation at 40 percent or above; a loss of real purchasing power for almost all Venezuelans; increased labor unrest and protests; and rolling shortages resulting from a variety of distortions and other problems. The Government of the Bolivarian Republic of Venezuela (GBRV) will have to finance a significant fiscal deficit and manage a severe external (foreign currency) shock, though it is likely to defer any visible and unpopular adjustments, such as increased taxes or a devaluation, until after the referendum to eliminate presidential term limits that President Chavez has proposed for early 2009. We believe many Venezuelans are unprepared for the magnitude of the economic problems they and their country will face, partly because the GBRV has to date downplayed the local impact of the global economic crisis. End summary.

2004-2007: Thriving Economy, Unsustainable Model

¶2. (SBU) After suffering a short but painful recession from 2002 to 2003 related to a national strike, Venezuela's economy rebounded quickly, with real growth of 18, 10, 10, and 8 percent from 2004 to 2007, respectively. During this period, rising oil prices allowed the GBRV to spend vast sums of money. The average price of the Venezuelan oil export basket rose from USD 33 per barrel to USD 64 from 2004 to 2007 (an increase of 94 percent), and central government spending rose an astounding 140 percent in nominal terms. This spending, which included transfers to poor Venezuelans through social programs known as missions, led to a huge increase in aggregate demand. At the same time, the private sector grew increasingly unwilling to make medium or long-term investments in productive capacity because of threats to property rights, symbolized by several large-scale nationalizations and Chavez's proposed constitutional reform (defeated in a December 2007 referendum). The impressive economic growth that accompanied the increased demand, therefore, was concentrated in nontradable sectors and dependent on continually increasing government spending and imports.

2008: The Decline Begins

¶3. (SBU) The problems inherent in the GBRV's economic model became manifest beginning in mid to late 2007. The most obvious sign of these problems were severe shortages of many staple goods, which peaked in early 2008. These shortages were the predictable result of rigid price controls in an inflationary environment. By relaxing price controls and subsidizing food imports, the GBRV substantially reduced these shortages over the course of 2008. Inflation worsened, however, from 22 percent in 2007 to 31 percent in 2008. If Venezuela's recent inflation was once primarily a monetary phenomenon (i.e., resulting from the liquidity increase that accompanied the GBRV's expansive fiscal policy), it has converted into a structural problem augmented by expectations. Local supply is not growing as fast as local demand, leading to higher prices and greater reliance on imports.

¶4. (SBU) Except for the relaxation of some price controls, economic policies in 2008 only exacerbated underlying problems. The GBRV further reduced incentives for anything but short-term private investment by another wave of announced nationalizations (the major ones still unpaid for), the decree of 26 laws that diminished property rights and implemented controversial aspects of the failed constitutional reform, harassment of private companies by tax and consumer protection authorities, and other measures such as the windfall profits tax. Many price controls remain, as do other distortions such as a fixed and increasingly overvalued exchange rate, currency controls, and an expensive gasoline subsidy. Labor regulations, labor unrest, bureaucracy, corruption, and decaying infrastructure

(particularly in electricity and ports) are also progressively increasing the cost of doing business in Venezuela. As a result of these factors, real GDP growth slowed to 5 percent in 2008, again concentrated in nontradable sectors.

2009: Oil Price Shock Adds Injury to Insult

¶5. (SBU) For an economy that was already faltering during summer 2008 with oil prices at record highs, the recent plunge in prices, if it holds, will be devastating. The Venezuelan basket has dropped from a monthly average high of USD 129 in July 2008 to USD 32 in December, a decline of 75 percent. Assuming an average price of USD 38 in 2009, PDVSA's former chief economist estimates PDVSA gross cash revenue would decline to USD 23 billion in 2009, as compared to USD 57 billion in 2008 (post estimate). If it occurs, this decline will deal a critical blow to the Venezuelan economy in three ways. PDVSA will have much less money available for investment, social spending, and transfers to Fonden, the GBRV's national development fund. GBRV revenue, more than half of which comes from taxes and royalties from oil activity, will be significantly lower. Finally, the country's trade surplus will be sharply reduced or - more likely - turn into a deficit, leaving fewer dollars for imports and transfers abroad.

When Will the Money Run Out?

¶6. (SBU) Given the likely precipitous decline in PDVSA revenue, the question of "when the money will run out" has become a favorite local theme. This question really has two components. First, the GBRV is expected to run a substantial primary fiscal deficit of between 4 and 7 percent, according to analysts' estimates. The second component relates to the GBRV's external (foreign currency) position, which at year-end 2008 consisted of USD 43 billion in the BCV's

international reserves and perhaps an additional USD 15 to 20 billion in several quasifiscal funds. (Note: Reserves rose from USD 38 billion to USD 43 billion in the last two days of 2008, apparently due to large sales of dollars to the BCV by PDVSA and Fonden, one of the quasifiscal funds. End note.) Asking when the money will run out is somewhat misleading, however, as the GBRV can use a variety of policy tools to reduce or finance its deficit and to prevent the BCV's reserves from drying up. A more realistic question is what tools the GBRV can use to stay afloat, and at what political and economic cost.

GBRV Policy Options: Pick Your Poison

¶7. (SBU) Venezuela's external position cannot be sustained through 2009 under current patterns. BCV reserves are largely determined by three components: a regular inflow as PDVSA sells the BCV some of the dollars it earns; a regular outflow as the BCV sells dollars for imports and other purposes authorized by CADIVI, the GBRV's foreign currency board; and periodic transfers of "excess reserves" from the BCV to Fonden. In 2008, PDVSA turned over roughly 65 percent of its export earnings to the BCV (per one analyst's calculation), and the BCV liquidated about USD 45 billion of authorized foreign currency requests. Were these patterns to continue, BCV reserves would be gone by early to mid 2010. Faced with this reality, the GBRV has no choice but to reduce CADIVI authorizations (indeed, it already is); it may also increase the percentage of PDVSA revenue sold to the BCV and/or draw down quasifiscal funds to import priority items.

¶8. (SBU) The GBRV has a variety of options to cover the fiscal deficit. Most analysts expect the GBRV to increase taxes (specifically by raising the value-added tax rate and implementing a tax on bank debits); slow down central government spending on long-term investment and transfers to state and local governments; issue bolivar-denominated debt (forcing local banks to buy it, if necessary); draw down existing bank deposits and quasifiscal funds; and reduce PDVSA investment spending at home and in Petrocaribe countries. The government is less likely to devalue the

bolivar or sharply reduce social spending. Almost no one believes the GBRV will cut subsidies to Cuba, raise domestic gasoline prices, or be able to access international financial markets (except perhaps for specific PDVSA projects).

¶9. (C) Each of these options has a political and/or economic cost. Reducing CADIVI authorizations will have a direct inflationary impact and probably lead to shortages, as imports will be reduced or moved to the parallel rate. Increasing taxes will increase inflation and reduce economic growth, and issuing local debt and reducing investment spending and transfers will also have a contractionary effect. Drawing down existing GBRV bank deposits will cause liquidity and solvency problems at a number of smaller and medium-sized banks. As President Chavez weighs his options, he will likely prioritize short-term political goals above all else, per his custom. For this reason, no one expects the GBRV to implement visible and unpopular measures such as raising taxes or particularly a devaluation before the proposed referendum. In contrast, there is some evidence the GBRV is already drawing down its deposits in the financial sector (with the predicted effects) and investment spending and transfers to state and local governments are slowing down.

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Slowing Growth, Rising Inflation, Shortages, Unrest
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¶10. (SBU) Most economists were predicting slower growth and higher inflation for 2009 even when oil prices were relatively high. The policies the GBRV will be forced to

adopt given low oil prices simply compound these trends. Assuming an average price of USD 52 per barrel for the Venezuelan basket, Sintesis Financiera, a respected local consulting firm, estimates real GDP growth at two percent and inflation of 40 percent or higher. Others are less sanguine: ODH, another consulting firm, estimates a contraction of two percent and inflation between 45 and 50 percent at USD 50 per barrel. Both firms offer alternate scenarios: the lower the average oil price, the worse the growth and inflation outlook. The more imports are restricted at the official rate, the more likely additional shortages of non-priority items become, as local manufacturers have trouble getting needed inputs. All of these factors - slower growth, higher inflation, and potential shortages - will increase pressure on the private sector, which has already struggled to contain labor unrest spurred in part by Chavista unions seeking state takeover.

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After the Party Ended: Impact on the Average Venezuelan
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¶11. (SBU) 2008 was the year the party ended for most Venezuelans. Datos, a market research firm, estimates the real purchasing power of poor Venezuelan families in the "E" socioeconomic class grew a stunning 181 percent from 2003 to 2007, thanks to government transfers and overall economic growth. (Note: Sociologists divide Venezuela's population into five classes; E is the poorest and largest class, accounting for almost 60 percent of the population. End note.) In the 12 months ending September 2008, it grew only five percent. During these 12 months, according to Datos, the real purchasing power of families in the D and C classes, which make up almost 40 percent of the population, fell by approximately 12 percent. For 2009 it is almost a given that, for the first time in six years, the vast majority of Venezuelans will find themselves worse off at year end, possibly significantly worse off.

Paying the Piper

¶12. (SBU) If oil prices stay low into 2010, Venezuela's economy will almost certainly be in a recession, and inflation will surge even higher. But it would be wrong to blame Venezuela's economic woes on low oil prices, just as it would be wrong to expect higher oil prices would lead to a meaningful recovery. Rising oil prices from 2003 through the summer of 2008 allowed the GBRV to mask an array of problems of increasing gravity, including, as noted above, decaying infrastructure, a bloated and inefficient bureaucracy (including at PDVSA), corruption, massive distortions from

price and currency controls, and ever-diminishing incentives to productive private investment. While they have grown worse, these problems are not unique to Chavez's tenure; indeed, they have contributed in varying degrees to Venezuela's economic stagnation since the 1970s. Putting Venezuela on a long-term path to prosperity will require addressing these problems and progressively reducing Venezuela's dependence on oil.

Comment: Are Venezuelans Prepared?

¶13. (C) We believe the majority of Venezuelans are not prepared for economic problems of the magnitude they are likely to face in 2009 and 2010. Although opposition media has featured numerous articles and programs about the country's economic vulnerability, the GBRV has to date downplayed the potential impacts of the global economic crisis on Venezuela. During his annual "state of the nation" speech on January 13, Chavez boasted Venezuela would not be

affected by the crisis. Despite this bluster, Chavez and his ministers have hinted at problems. For example, Chavez stated on another occasion Venezuela would be affected marginally, but he promised social spending would not be cut and asserted the government has ample reserves to see it through the crisis. Even if Chavez and his ministers understand the gravity of Venezuela's economic situation, they will not acknowledge it until after the referendum to eliminate presidential term limits (indeed, the poor economic outlook is the primary reason Chavez wants the referendum held as early as possible). As a result, many Venezuelans, and especially those inclined to support Chavez, do not anticipate the coming economic problems. According to Datos, 58 percent of people in class E (the socioeconomic class most supportive of Chavez) think the country is in good shape, in contrast to only 26 and 18 percent in classes D and C, respectively. We will discuss the political implications of Venezuela's likely economic unraveling septel. End comment.

Background Cables

¶14. (SBU) For more background on topics mentioned above, please see the following cables: nationalizations - 2007 CARACAS 59, 2007 CARACAS 411; 2008 CARACAS 1690; constitutional reform - 2007 CARACAS 2013; shortages - 2007 CARACAS 2381, 2008 CARACAS 1152; the 26 laws - 2008 CARACAS 1127; increased harassment by SENIAT - 2008 CARACAS 1463; the windfall profit tax - 2008 CARACAS 559; decaying infrastructure - 2008 CARACAS 1228 (electricity), 2008 CARACAS 1607 (ports); PDVSA finances - 2008 CARACAS 276; quasifiscal funds - 2008 CARACAS 1554; transfers to state and local governments - 2008 CARACAS 1453; banks - 2008 CARACAS 556, CARACAS 4; CADIVI - 2008 CARACAS 647, CARACAS 3; term limits referendum - 2008 CARACAS 1739, CARACAS 80.
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